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The deficit country is absorbing more, taking consumption and investment together, than its own production. In return it has a permanent obligation to pay interest or profits to the lender. Whether this is a good bargain or not depends upon the nature of the use to which the funds are put. If they merely permit an excess of consumption over production, the economy is on the road to ruin.

Joan Robinson, *Collected Economic Papers, Volume IV,* 1973

FROM CREDIT INFLATION TO DEBT DEFLATION

There has been a stellar year-end rally in the stock markets, but there is no year-end rally in various major economies. Peering into the beginning of the new year, the potentially greatest negative surprises definitely loom in the bubble economies of the Anglo-Saxon countries and China. For years, the common characteristics of the Anglo-Saxon group — the United States, Britain, Canada, Australia and New Zealand — have been soaring house prices, consumer borrowing-and-spending binges, plunging personal savings and, except for Canada, huge trade deficits.

China's bubble is in capital investment.

Of the five Anglo-Saxon countries, the ones most dependent on the housing bubble in sustaining their economic growth are definitely the U.K. and the U.S. economies. The outstanding feature of both economies is an extraordinary shortfall of employment and real income growth.

The trouble with asset bubbles as growth engines is that all that is needed to obstruct their working is stalling asset prices. That is what has happened in England. A virtual halt to house price inflation has promptly broken the economy's growth stance. Quarterly real GDP growth since early 2004 is down from 3.7% to 1.5% recently, both at annual rate.

We increasingly wonder what is simultaneously happening in the United States. It made headlines that third-quarter real GDP growth was revised upward to an annual rate of 4.3%, its fastest pace since early 2004.

As it is so often, the devil is in the detail. Since the GDP figures measure changes in *quarterly averages*, even big changes in the monthly pattern may therefore get lost. By the GDP figures, consumer spending in the third quarter has soared by $81.9 billion. But measured from month *to month*, it was down by $14.3 billion over the quarter. The reason is that sharper declines in August – September more than offset the sharp rise in July. In the last letter, we made an estimate that real consumption had declined by 7% at annual rate during the three months to October. The final official figure now is 4.8% down, not up.

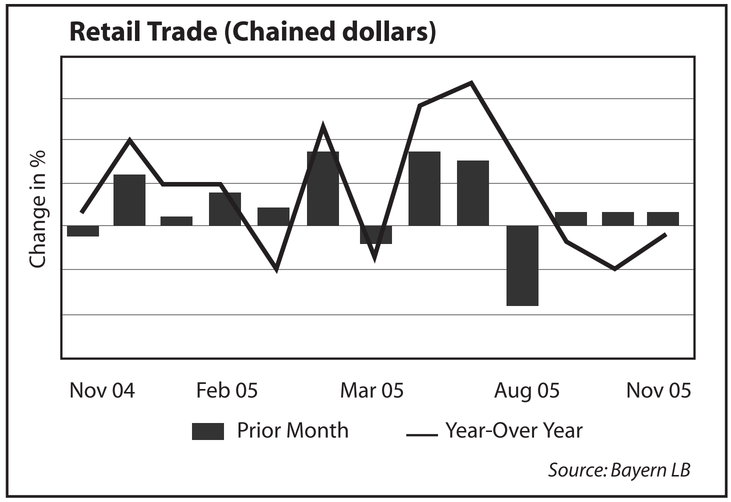
Rarely have opinions and news about the U.S. economy and its financial markets been as contradictory as in recent months and weeks. The quandary begins with the confusing profligacy of available data. That is one problem. Another is a general narrow focus on the headline news. And a third problem is unreserved acceptance of numbers reported by the Bureau of Economic Analysis (BEA) and the Bureau of Labor Statistics (BLS), regardless of obvious gross inconsistencies between them.

In its *World Economic Outlook* of September 2005, the International Monetary Fund (IMF) conjectures about the U.S. economy, saying the following:

> *Incoming data — including manufacturing and services sector surveys and retail sales — generally suggest the momentum of the expansion remains solid. However, the near-term outlook has been overshadowed by the devastating loss of life and property caused by Hurricane Katrina…*

In 2006, growth is expected to return to trend, driven primarily by a pickup in investment, reflecting firms' healthy balance sheets, strong profitability and capital stocks that are below trend in some sectors.

Broadly, this description perfectly reflects the prevailing highly optimistic consensus view about the ebullient state of the U.S. economy among economists and the public. In its Dec. 12, 2005, issue, *BusinessWeek*, under the title "Why Economic Growth Is Galloping," displayed virtual ecstasy about the U.S. economy's current and impending performance: *"The economy is proving as unstoppable as the 11–0 Indianapolis Colts. Consumers have kept spending even in the wake of sharply higher energy prices and after their confidence was pummeled by this summer's hurricanes."*



Many similar reports in the media certainly go a long way to explain the rally in the U.S. stock market. Focusing on monthly, rather than quarterly, changes, we identify a dramatically different picture, as evidenced by the chart on the right.

THE UNSOLVED BOND CONUNDRUM

A radically different message, however, seems to come from the behavior of intermediate and long-term U.S. interest rates. It is perhaps the biggest puzzle of the past two years that they have stayed at their unusual lows in the face of general economic euphoria and a 300-basis-point uplift by the Federal Reserve.

As a consequence, the yield curve has flattened much earlier than expected. While the consensus does not seem to worry, it is a fact that in the past this has always signaled an impending recession. Why not this time?

Without offering any explanation, Fed Chairman Alan Greenspan recently argued that a flat yield curve would not act as a recessionary signal this time, while incoming Chairman Ben Bernanke sought to provide an alternative benign explanation with his "global savings glut" speech in early 2005.

The search for sound and logical reasons continues. Many see a main reason in the large bond purchases of Asian central banks. Mr. Greenspan, in particular, has argued that the low longer-term interest rates reflect the Fed's eminent policy posture over the past few years, leading to the low core rate of inflation and sharply diminished risk premiums.

None of these explanations holds water. Without question, the U.S. bond purchases by Asian central banks help to keep U.S. longer-term bond yields down. Yet they are grossly insufficient to accommodate the credit deluge flooding the U.S. economy and its asset markets at these low rates.

In the United States, it is the popular assumption that long-term interest rates are fundamentally determined by inflation rates and expectations. The additional new feature now is diminished risk premiums. Past experience may suggest this connection, but past experience is pretty worthless under the present diametrically different conditions of exploding credit and collapsing savings.

To have low interest rates, it definitely requires more than just a low inflation rate and confidence in the central bank. It requires a sufficient flow of money to accommodate the ongoing credit expansion, including the bond purchases. What has happened in the United States in the past four or five years is an unprecedented money and credit deluge holding short-term and long-term interest rates at record lows.

The first decisive question to ask in the face of this extraordinary development is the source of all that money accommodating the credit deluge. Principally, there are two possibilities. The difference is of crucial importance. The one source is the limited supply of savings; the other one is possibly unlimited inflationary money and credit

inflation.

It happens that in the United States' case, the identification of that source is particularly easy. With savings in collapse, credit accommodation must essentially have come in total from inflationary money and credit creation. Implicitly, this applies equally for asset purchases, whether housing, stocks or bonds, for which the steep yield of the last few years was the ideal condition.

After Treasuries, the leveraged speculators turned to higher-yielding investment-grade corporates. Then it was junk bonds, then emerging debt and then structured credit. What has lowered U.S. longer-term interest rates and squeezed the risk premiums was manifestly the unprecedented credit excess going into carry trade, engineered by the Fed.

This talk of diminished risk premiums as the cause of the low long-term interest rates virtually puts the truth on its head. As yields fell across the board, the speculators had to incur rising risks in order to maintain their spread in carry trade.

For us, Greenspan's reference to low-risk premiums as an explanation for the low long-term rates just serves as a diversion from the all-too-obvious true cause: the greatest credit excesses in history.

Recognition of these facts has to be the starting point for any assessment of the future course of U.S. longer-term interest rates. A total collapse of the carry trade, a sure consequence of an inverting yield curve, would send long-term rates soaring.

While Mr. Greenspan has argued that the yield curve no longer plays the same crucial role for the economy as in the past, we think that under these conditions it matters more than ever, both for the economy and the financial system.

All the more puzzling is the stubbornness of the low long-term interest rates, defying the yield curve's actual flattening. One possible explanation is a major shift in the financing of the carry trade to a cheaper euro and, in particular, yen. Strikingly, the growth of financial credit, i.e., by financial institutions other than the banking system, showed a steep plunge in the third quarter.

In the end, though, one has to assume that leveraged speculators stick to their bond holdings or even add to them, expecting that a weakening economy will force the Fed to sharp new rate cuts.

A DRASTIC CHANGE IN THE USE OF CREDIT…

Although strongly sympathizing with the downbeat forecasts for the U.S. economy, we have trouble with the optimistic assumptions of still lower long-term interest rates. The starting point for our doubts is the preposterous pace of credit expansion shown in nonfinancial credit, despite 12 rate hikes, with no sign of the slightest letup.

So far, there has been zero monetary tightening. The just-published Flow of Funds Accounts of the Federal Reserve shows a rise in nonfinancial credit for the third quarter of 2005 to a new record-high annual rate of $2,296.6 billion, of which, also a record high, consumer credit was $1,235.9 billion.

To understand the problem of credit excess, it needs a historical perspective. (See next page.)

These numbers make horrible reading in two respects. One is the sharp acceleration in the speed of credit growth over the years, and the other is the stunning contrast between exploding credit and collapsing savings.

Now compare the credit figures of the 1990s with those since 2000. Even in the boom year of 2000, nonfinancial credit expanded by just $864.7 billion. During the first three quarters of 2005, it has — after rapid acceleration — been expanding by $2,202.2 billion at annual rate.

The difference is shocking. Even more shocking is the extremely poor job growth resulting from this unprecedented credit deluge. During the first four years of the recovery after the 2001 recession, decried as a "jobless recovery," employment grew by 7.6%. For the current recovery, it is 2.6%.

There has, in short, been a dramatic deterioration in the traction of credit growth on economic activity. It was

	Growth of Credit			Net National Savings
	Nonfinancial	Financial (in $billion)	Total	
1990	655.9	225.0	880.9	328.8
1995	684.7	439.0	1,123.7	483.1
2000	834.3	788.6	1,622.9	582.7
2001	1,107.8	890.5	1,990.3	376.2
2002	1,332.4	835.5	2,167.9	197.1
2003	1,672.7	1,029.0	2,702.7	142.7
2004	1,903.3	781.7	2,685.0	136.8
2005*	2,202.2	861.6	3,063.8	

* available numbers for the first three quarters annualized
Source: Federal Reserve, Flow of Funds Accounts

in the early 1990s, actually, already much lower than in the earlier decades of the postwar period.

It should be clear that this has serious negative implications, if this disconnect becomes structural. Closer investigation of the underlying causes compels us to the conclusion that, in fact, it is structural, and this for obvious reasons.

Money and credit growth do not have determined economic effects. It is decisive to whom and for what purpose credit is extended. In this respect, the past 20 years have witnessed substantial changes in all industrialized countries. But these changes have mainly been most drastic in the United States for two reasons. One reason is a general growing propensity toward consumption; and the other reason is an obsession with shareholder value, at the expense of organic capital investment.

In earlier years, credit generally financed spending in the economy. Businesses borrowed for capital investment, and consumers borrowed for purchasing durables and housing. All this borrowing impacted national product and incomes directly and positively.

But starting in the 1980s, new credit in the United States increasingly went into two other outlets outside the national product. One was soaring imports, as reflected in the ballooning U.S. trade deficit, and the other was asset purchases in the domestic and global markets.

…AND A DRASTIC CHANGE IN THE INFLATION PATTERN

One of the results is a general confusion about inflation. Historically, American policymakers and economists in general only recognize one single kind of inflation — rising consumer and producer prices, particularly the former. To understand inflation, however, it is necessary to distinguish between cause and effect.

There is always one and the same cause, and that is excessive money and credit creation. But depending on possible different uses of the borrowed money, there can be very different effects. By the early 1980s, a sharply accelerating money supply in relation to GDP aroused great fears of a comeback of consumer price inflation that tenaciously failed to materialize. Even for the experts in the central banks, it took some time to realize the obvious, that credit excess was fueling inflation in asset prices, instead.

A trade deficit, in turn, implicitly reflects the fact that a country spends in excess of its production. For this to happen, it inexorably needs credit, enabling people to spend in excess of their current income. From this perspective, it, too, is manifestly an expression of inflation.

People borrow to spend. Observing a sharply accelerating credit expansion, it is, in general, easy to identify the target of this spending. There cannot be the slightest doubt for anybody that the credit deluge of the past few years

in the United States has mainly flooded into housing — boosting its prices. Yet policymakers and many economists dare to flatly deny the direct connection.

In his first speech as Fed governor (October 2002), Mr. Bernanke said, *"Another possible indicator of bubbles cited by some authors is the rapid growth of credit, particularly bank credit. Some of the observed correlation may reflect simply the tendency of both credit and asset prices to rise during economic booms."*

It certainly needs a lot of courage to discard such a blatantly obvious causal connection as merely coincidence.

THE KEY ROLE OF SAVING

But what exactly is "credit excess"? Is there a measure? Yes, a precise one, and that is available savings out of current income, thus commonly identified by the leading economists of all schools of thought.

It happens that Knut Wicksell himself, the famous inventor of the "neutral," or "natural," interest rate, gives a precise answer to this question in *Lectures on Political Economy*, Vol. 2, "Money," (pgs. 192-3):

> *The accumulation of capital consists in the resolve of those who abstain from the consumption of part of their income in the immediate future. Owing to their diminished demand, or cessation of demand, for consumption goods, the labor, material and land which would otherwise have been required in their production is set free for the creation of fixed capital for future production and consumption, and is employed by entrepreneurs for that purpose with the help of the money at their disposal by savings…*
>
> *The rate of interest at which the demand for loan capital and the supply of savings exactly agree, and which more or less corresponds to the expected yield on the newly created capital, will then be the normal or natural real rate.*

The latter sentence holds the key. Put colloquially: The natural rate of interest is where credit demand and the supply of savings exactly agree. To keep credit expansion and available savings in equilibrium is the fundamental function of interest rates, of which central banks have to take care.

For most people, saving simply means money. Wicksell makes clear that it has two different functions in the economic process. The crucial one is that current income not spent for consumption releases productive resources for productive investment. Investment cannot take place if consumers do not release resources through saving. And the other is that, in the same vein, saving provides the finances for asset creation or asset purchases.

As a rider, here is the description of saving by J.M. Keynes: *"Saving is the act of the individual consumer and consists in the negative act of refraining from spending the whole of his current income on consumption."* This view about saving as implying diminished consumption for the sake of capital investment has been common to all schools of thought in economics.

We realize that this thinking about saving as an act of abstention from consumption is totally unfamiliar to most American economists today. But their forerunners knew perfectly well. In the years of Reaganomics in the 1980s, there raged a lively discussion about the necessity of sufficiently high savings for sufficiently high capital investment. Today, there is total silence, even from academic America. Why?

What has happened to domestic savings in the Anglo-Saxon countries during the past few years is unprecedented in history. In different degrees, its steep fall, reflecting a rising share of consumption in GDP, has crowded out capital investment and foreign trade. These are the inexorable destructive effects of dis-saving, which the bullish consensus in the United States flatly refuses to see.

It has to be realized that the atrocious imbalance between credit expansion and available savings is at the bottom of all distortions in the U.S. economy. One of the results is an economy where rampant inflation in some areas (asset markets) coincides with savage deflation in others (employment and income creation).

Since 2000, credit inflation in the United States has run without any brake. That is the one most important fact to see. An extremely uneven distribution of this credit deluge across the economy and its financial system is the other important fact.

The biggest recipients by far have been the asset markets, feeding rampant asset inflation with sharply falling long-term interest rates, by way of escalating carry trade. Exploding wealth in the asset market was the great spectacle of the 1980s. Rising asset prices, however, do not necessarily induce higher spending. That depends on the response of businesses and consumers.

In Japan, it was primarily businesses that reacted to the developing asset bubbles with higher investment. In the United States' case, it is overwhelmingly the consumer who responded with heavy borrowing and sharp increases in spending on durables and housing. Businesses, too, continue heavy borrowing, but for mergers, acquisitions and more and more stock buybacks.

There appears to be little appreciation in the United States that this new policy and growth pattern represents a radical departure from its traditional pattern. In days of yore, monetary policy aimed to influence demand and spending growth directly. The resulting income growth furnished the bulk of the money being spent. Associated changes in asset prices were viewed as secondary byproducts of changes in economic activity.

Now the shoe is on the other foot. The chief actor is the asset price inflation, providing prodigious collateral for prodigious consumer borrowing and spending. However, this new policy stance shows a striking, fatal deficiency in its economic effects, which is ultimately defeating it.

This deficiency consists of a protracted unusual sluggishness in employment and income growth. What has more importance for people than a rising income? To maintain the living standard, heavy borrowing to supplement badly lagging incomes is generally required. While the long, sharp rise in house prices facilitates the borrowing and also comforts people financially, it is definitely not a sustainable solution.

Above all, though, it raises two highly critical questions: *first*, the sustainability of economic growth under these extraordinary conditions; and *second*, the sustainability of the housing bubble and the runaway consumer borrowing.

There is no discussion and no questioning. Hailing the housing bubble, though plainly driven by artificially low interest rates, as "wealth creation," policymakers and economists rave about the discovery of a fabulous new monetary policy stance enriching the nation as never before.

WHAT SUCCESS?

In the end the all-important question is what the new policies, with their unprecedented monetary and fiscal stimulus, have achieved in terms of the two measures that are truly decisive for the standards of living. These are employment and income growth.

As described in some detail in the last letter, the current U.S. economic recovery that began in November 2001 is — despite all the associated hype — the weakest one by any measure, except residential building. At the same time, we warned that changes in the measurement of various important aggregates grossly distort the picture in favor of the latter.

Of all measures, the current U.S. economic recovery looks by far best in terms of real GDP growth. As this is, moreover, the most popular and widely used general measure of national economic performance, it has generated a common perception that the U.S. economy has done extraordinarily well in the last few years.

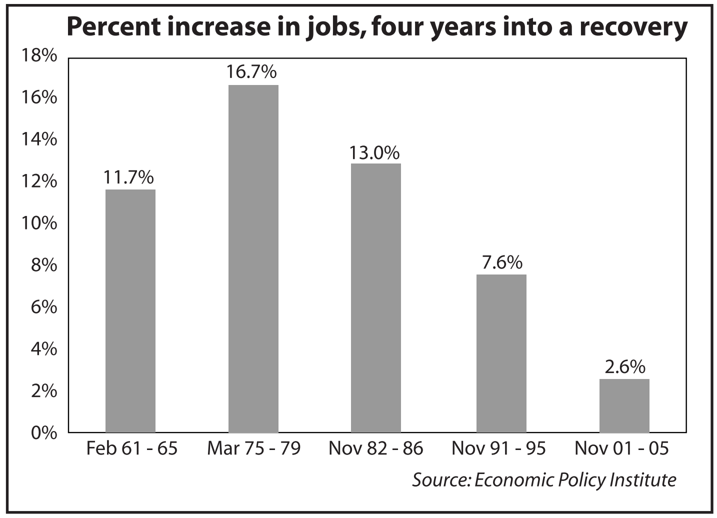
Yes, but it has performed extraordinarily badly by the measures of employment and incomes, which happen to be decisive for the living standards of the great majority of working people.

The chart on the facing page shows the changes in total employment for all postwar recoveries four years into a recovery. Strikingly, the last column, concerning the current U.S. economic recovery, is completely out of line with all predecessors.

It is a shocking picture. Yet we must admonish that the job growth recorded since 2000 has an obscure source. Apart from about a million government jobs, it has largely accrued from the estimates of the "net birth/death" ratio model.

The table below shows total reported job growth and, separately, its net birth/death component. But first a few general remarks about the development over these years. Employment grew until March 2001, the declared start of the recession, to 132.5 million jobs. It then declined until May 2003, to 129.8 million. Its latest number, for November 2005, was 134.3 million.

For the period from April 2001–November 2005, the BLS reported an overall increase in payrolls of 2.075 million, of which more than 500,000 were government jobs. The reported increase for the private sector was about 1.5 million. This compares with a contribution of 2.813 million jobs over this period through the net birth/death model.



To wit, without the almost 3 million new jobs created through the net birth/death model, employment in the private sector would now be well over 1 million lower than than it was in the 2001 recession.

Job Growth From April 1999 to November 2005 (in 1,000s)

	Reported	Net Birth/Death	
April 1999 – March 2000	2,998	30	
April 2000 – March 2001	849	193	
April 2001 – March 2002	–1,773	91	payroll 132,214,000
April 2002 – March 2003	–428	470	
April 2003 – December 2003	402	695	
January – December 2004	2,077	836	
January – November 2005	1,716	812	payroll 134,289,000

Source: Bureau of Labor Statistics

Considering the overriding importance of this model in job creation, it seems opportune to recall some facts about the essence and the origin of these estimates. Its beginnings go back to the early 1980s.

During the Reagan boom, corporate downsizing appeared to wreak havoc with the surveys. While numerous large firms reported big job cuts, IRS tax data showed sharp increases in jobs and income. From this new discrepancy, the BLS concluded that the revolution in corporate governance and technology had significantly changed the rules of the employment game. Small businesses, many of them new, were apparently creating an enormous amount of new jobs that were not captured by the regular survey.

This led to the introduction of an estimated "bias," or "plug," factor, supposedly accounting for the job creation of new firms during periods of strong economic growth, which is typical of recoveries from a recession. On this account, the BLS started adding a statistical 35,000 jobs a month to the numbers it elicited from its regular monthly "establishment surveys."

Observing during the dot-com era of the late 1990s that new small firms were truly the most vibrant part of the economy, the BLS switched to the "net birth/death" model in 2000, based on how many new firms are created and shuttered. In its wake, the annual estimates soared to more than 800,000 in the last two years.

Based on the experience during these years, the model explicitly assumes that measurable job losses through

business deaths have their invariable counterpart in even greater job creation through new small businesses. Ergo, the greater the job losses through business deaths, the greater the assumed job gains through the BLS and its net birth/death model.

What a logic! Trying to be generous with the inventors of this model, we concede that their assumption of a coincidence between job losses through dying firms and job creation through new firms does make some sense in times of strong economic and employment growth and tight labor markets.

Possibly, if not probably, it was a pretty valid assumption for the boom years of the late 1990s, when new small dot-com firms mushroomed as never before. But it is manifestly an absurd assumption for the very subpar recovery of the past few years, which is particularly subpar in terms of job creation.

To complete this section, we have to add that this is by no means the end of the delusion. Implicitly, the BEA of the Commerce Department, which calculates the income component in the national statistics, takes the reported job gains as basis for its calculations of wage and salary incomes.

In a recent article in *The New York Times* titled, "The joyless economy," Paul Krugman brandished the fact that by the measure of GDP, the U.S. economy is rising at a pretty fast clip, while people are increasingly disgruntled when failing to see any personal benefits from the supposed boom.

"Never mind the GDP numbers: Most people are falling behind," says Mr. Krugman, drawing the conclusion that *"It's much harder to explain why. The disconnect between GDP growth and the economic fortunes of most American families can't be dismissed as a normal occurrence… At this point, the joylessness of the economic expansion for most Americans is a mystery."*

Obviously, Mr. Krugman belongs to the many American economists for whom government statistics are sacrosanct. We have been drawing attention to this strange disconnect for years. But for us, it never was a mystery. There is one obvious and reasonable explanation, and that is statistical distortion.

That GDP growth looks by far best for this economic recovery has its overt reason in the fact that it is an abstract aggregate concerning everybody and nobody. Moreover, it is easily levitated by creative accounting of the inflation rate, of which the BLS is for well-known reasons a great master. Just 2%, more or less, in the inflation rate makes all the difference between apparent solid economic growth and stagnation.

By comparison creative accounting of nonexistent jobs has limits, because the job situation directly affects people. Even the nearly more than 800,000 new net birth/death jobs of 2004 and 2005 are a tall order. For good reasons, the numbers are hidden in an attachment to the report, which few people bother to read.

PRODUCTIVITY BOGUS

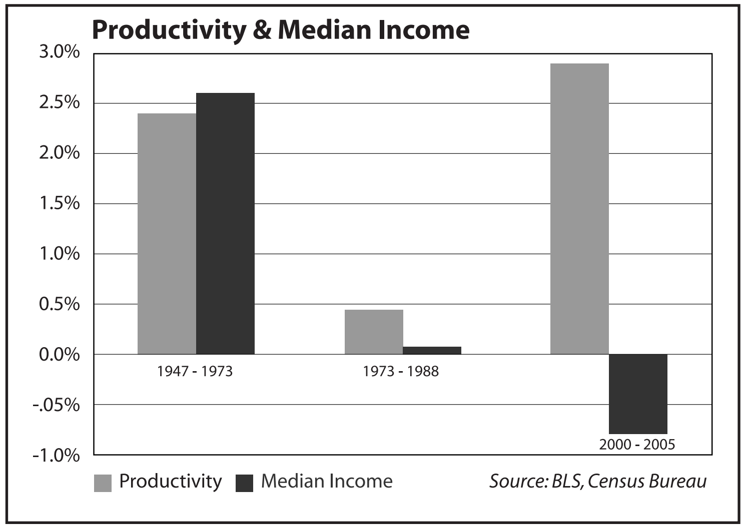
The convenient and apparently plausible explanation for the big disconnect between the growth of GDP and employment is the record-high productivity growth reported for this recovery.

Again, we can only express our amazement how readily and uncritically American economists accept statistics, however implausible they appear. Reported miraculous productivity growth conflicting diametrically with simultaneously reported miserable income performance is another most striking and shocking case of this kind.

At the same time, slowing nominal wage growth is colliding with faster inflation. On Oct. 28, 2005, the BLS reported that employers' wage costs — equal to employees' wage income — had grown 2.3% over the prior year. Presenting these numbers for the first time with inflation adjustment, it disclosed a decline in real terms by 2.3%. It is the largest loss on record.

According to the latest annual report of the Census Bureau, median household incomes have fallen over five years in a row by 3.8% altogether.

Oddly, the most splendid productivity performance of the whole postwar period coincides with the most miserable income performance. As a rule, one could always take the rate of productivity growth as a proxy for concurrent wage growth, not only in the United States but also around the world.



Wage increases even lagged inflation rates, let alone productivity gains. As falling real wages cumulated with the very poor employment gains, income growth in the past few years has been at its worst in the United States in the whole postwar period. The poor employment growth makes the decisive difference to all past experience.

It also makes the great difference to the horrible 1970s experience. After the oil shock of 1973 and the decoupling of the dollar from gold, wage growth persistently lagged the sharply rising inflation rate. Over 10 years, average weekly earnings fell a steep 15% in real terms. But in the aggregate, a surge in employment from 85 million to 100 million, or 17.6%, virtually offset the income losses from rising inflation. The net effect was protracted stagnation, rather than a decline in median family incomes.

To mention a few other differences between the 1970s and the present in passing: Then, the personal saving rate ranged between 9–10% of disposable income, compared to negative this time. Consumer borrowing was almost nonexistent. It rose from $627.9 billion to $1,733.4 billion between 1973–83. Please note, these are not the annual increases. They are the amounts of total outstanding debt.

Strikingly, the Fed under Paul Volcker could finish the inflationary ordeal of the time with precipitate rate hikes to the dizzying level of 20%. In contrast, the Greenspan Fed has felt it necessary to stretch an overall rate hike from 1% to 4% in mini-steps over 1 1/2 years. Such extreme caution in applying the monetary brakes certainly gives some idea of how they feel about the present strength of the U.S. economy and its financial system.

THE PLEASANT SURPRISE — PROFITS

But hasn't the productivity surge had the beneficial effect of a tremendous boost to profits, which in turn is bound to boost corporate capital spending? Again, it seems necessary to correct a popular error. Contrary to general perception, labor productivity growth, implying falling labor costs, does not raise profits just by itself. For that to happen, spending that increases business revenues is also required.

Fortunately for American businesses, this prerequisite rise in their revenues did materialize from two sources, providing consumers with ample cash for spending in excess of their earned incomes. Big tax cuts by the government were one source; the housing bubble inspiring and facilitating the consumer's stampede into debt was the other.

One of the great pleasant surprises of the past few years has been double-digit growth of business profits flooding the firms with cash. It seems plausible to explain this with the stellar productivity growth. Yet it is mistaken. In essence, there is but one single way to pile up cash, and that is by spending less than one's revenue. That is precisely what the nonfinancial business sector in the United States has been doing for some years.

On closer look, this has two reasons. One is protracted restraint in business spending on capital investment, certainly a very negative reason. The other reason is that two other sectors in the economy have been spending lavishly. They are the government and the private household sectors. Both have been spending in excess of their current revenue as if there were no limit.

Put plainly and categorically, the surge in business profits over the past few years in the United States has mainly been the product of soaring credit-financed spending by consumers and the government. What matters crucially for the generation of business profits is that the money for this spending has come from government and consumer borrowing, involving for businesses no expenses.

BUT THERE IS A GIGANTIC LEAK

However, there is a gigantic leak in this spending stream toward businesses, and that is the huge U.S. current-account deficit. Running lately at around $800 billion per year, it has more than doubled since 2000. The recipients of this spending outflow are foreign creditors and producers of the goods and services that the United States imports, mainly the latter.

There is a lively dispute about whether this deficit matters for the U.S. economy in a negative way. Many American economists even hail it as a great positive by helping to restrain inflation. It does not occur to them that this inherently falsifies the inflation picture and thereby misleads monetary policy using the inflation rate as its guide.

Any judgment about the U.S. current-account deficit's implications for the economy has to start with the recognition that it acts dollar for dollar as a subtraction from the current spending and income stream. For some time this drag has been of a magnitude that would have driven the U.S. economy straight into recession.

To offset the drag, it requires new demand creation through new credit creation. This is what the Federal Reserve has been readily delivering for many years with wide-open money and credit spigots. It is like a ship with a huge leak in its hull devouring fuel to keep afloat. Please take another look at the table on page 4, showing the rapidly rising tide of credit that it has been needed to move the U.S. economy since 2000.

The sharply higher credit and debt dependence of the economy is the first evil effect of the chronic trade deficit, involving both higher domestic and foreign borrowing. But there is further severe damage, in essence structural damage.

It arises from the fact that the credit expansion to offset the trade-related spending and income contraction fosters entirely different employment and spending. The obvious cardinal victim of the trade deficit is manufacturing, showing a loss of almost 3 million jobs since 2000, a decline by 18%. While productivity growth, for sure, also contributed, the total job loss vastly exceeds its potential effect.

The crucial point to see is that the alternative job gains through the credit expansion implemented to compensate for the trade losses in manufacturing occur in entirely different sectors, i.e., in construction, financial services, temporary help services, education, leisure and hospitality and government. Most of them, actually, derived directly or indirectly from the housing bubble.

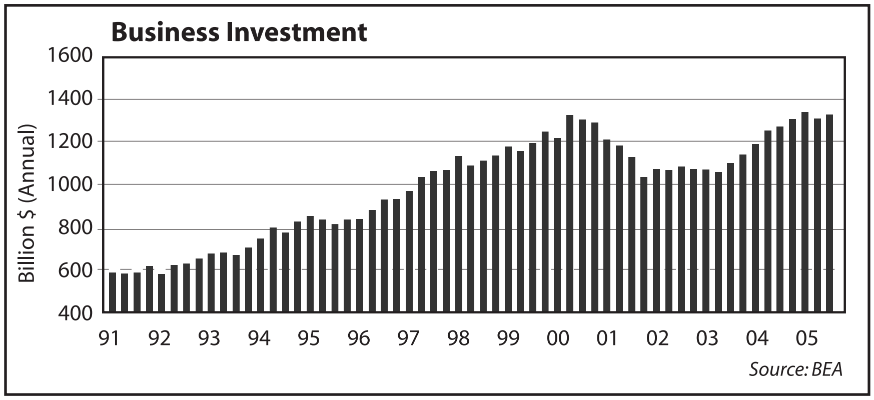
This is the second harmful effect of the huge U.S. trade deficit — distortions and dislocations in the employment and production structure. Manufacturing contracts while services proliferate. On the surface, this exchange may seem irrelevant. In reality, it progressively downsizes the economy's production structure. Manufacturing is the sector in the economy with the highest capital formation, the highest productivity and the highest wages. Most service jobs are rock bottom in all three respects.

From the macro perspective, this involves a progressive shift in the U.S. economy's resource allocation away from investment and net exports to consumption.

THE GREAT LAGGARD: BUSINESS INVESTMENT

We come to another abnormality in the U.S. economy's present recovery. That's the extraordinary weakness in business investment. Despite the strong profit growth and extremely liquid balance sheets, it has remained lackluster. Nonfinancial fixed investment in the third quarter of 2005 exceeded its pre-recession level by just 6%. This compares with an increase for consumption by 17.4%, for residential building by 36.8% and for overall government spending by 16.1%. While temporary generous tax incentives did draw out some spending, that effect has faded.

The table captures gross investment. A better measure, though, is net investment, i.e. investment exceeding depreciations implicitly increasing the economy's capital stock. As a rule, business fixed investment has always boomed after the Fed had eased in response to a recession. After the 1991 recession, net investment more than doubled within the following four years. Since 2000, in contrast, net investment has almost halved from $404.8 billion to $223.7 billion.



For decades it has been the rule that business investment spending exceeded corporate cash flow from depreciations and retained earnings. In 2000, this so-called financing gap amounted to $310.9 billion. As businesses slashed their investments, this gap shrank to a trickle in the following years. But the third quarter of 2005 witnessed a drastic deterioration. Investment spending lagged the cash flow by $197.5 billion.

Assuming pent-up investment demand, the consensus has no doubts that the highly favorable development of profits and cash flow assure an imminent surge in business fixed investment. But businesses appear to have quite another use for their surplus cash. Most of it is disappearing in mergers, acquisitions and stock buybacks. In the third quarter of 2005, equity withdrawals totaled $446.2 billion at annual rate, after $362.6 billion in the prior quarter.

Compared to $118.2 billion at the height of the high-tech boom in 2000, this looks like a sea change in corporate policy favoring higher share prices to higher capital investment.

While equity withdrawals tend to boost earnings per share, they unfortunately do nothing to increase productivity and jobs. What they create instead is mountains of debt, especially junk bonds.

EXCESS DEBT OR EXCESS LIQUIDITY?

There is a decidedly bullish tone in most reports about the U.S. economy's prospects in 2006. High productivity growth, tame inflation, low real interest rates, record-high household net worth and, above all, roving "excess liquidity" are the common favorite arguments. With few exceptions, forecasters close their eyes to record-high debt levels accumulating at record speed and badly lagging inflation-adjusted income growth.

Reading so much about the wonderful "excess liquidity" buoying asset markets, it seems to urgently need some explication. Assessing liquidity, it is necessary to distinguish between two different sources.

The one is "earned" liquidity from savings out of current income. It is the kind of liquidity that used to govern markets. The other kind of liquidity, governing many markets now, is "borrowed" liquidity, generally derived from exploiting a positive yield curve.

It has to be realized that the two sources create liquidity of utterly different quality. "Borrowed" liquidity accruing from borrowing against inflating asset prices is destined to disappear when asset prices decline. The reality behind this kind of liquidity is really "excess debt" fueling the asset inflation. It has to be realized that all the liquidity sloshing around in the United States is entirely of this origin.

While the financial system and the large speculating community have exploited the asset inflation through carry trade for prodigious profits, the people are using it to offset their falling wage and salary income. Using the inflating house prices as collateral and regarding it as a gain in their wealth, they readily keep stampeding into higher and higher debts to maintain their living standard.

The obvious big problem with this kind of wealth and liquidity creation is that it depends on permanent asset inflation to be delivered by loose monetary policy. This means, in essence, that in reality the Federal Reserve has no option for a true monetary tightening. Under no circumstances can it allow a major decline of asset prices, because it would inexorably depress them.

Yet there looms a second big and unrecognized problem in this economic and financial development. That is a progressive loss of traction of credit growth on economic growth. The gargantuan trade deficit, as earlier explained, is one reason.

Yet there is a major second one. It derives from the structural changes in the U.S. economy that we have identified — a growing share of unproductive consumption in GDP, against a shrinking share of productive capital investment.

There is a world of difference between the two in their financial implications, of which few people seem aware. Debt for productive capital investment is self-financing through depreciations and their reinvestment. Compare this with the effects of borrowing for unproductive purposes. It must compound itself at an increasing rate to maintain its effects.

With consumption and also financial speculation for quick profits as national priorities, the U.S. economy and its financial system have become addicted to runaway unproductive debt accumulation. Unproductive debt is, moreover, the relentless producer of ever-faster debt growth through the capitalization of unpaid compound interest, also called Ponzi finance.

Nobody is taking this threat seriously because everybody is counting on the possibility of reducing or liquidating their debts painlessly by selling some assets. But later concerted selling in the absence of liquid buyers will send asset prices crashing across the board.

This is the relentless final process described by Professor Irving Fisher in his "Debt-Deflation Theory of Great Depressions": *"The very effort of individuals to lessen their burden of debts* [by selling assets] *increases it, because of the mass effect of the stampede to liquidate in swelling each dollar owed."*

CONCLUSION:

U.S. internal debt rose $3,174 trillion, to $38,829 trillion, in the fiscal year ending September 2005. This rise was equivalent to 25% of the entire GDP. Net foreign claims against the United States increased $1.25 billion to $5.5 trillion. This gigantic surge in indebtedness compares with simultaneous GDP growth of $782.2 billion, and $397.2 billion in real terms. Consumer spending accounted for 74% of the GDP growth. Savings are negative for the first time ever.

Extremely loose monetary policy since the early 1980s has worked well in inflating asset prices. But the burst of the equity bubble in 2000–02 appears to have been the inflexion point. Since then, credit and debt growth is escalating with less and less effect on the markets and the economy. Only the housing bubble is holding recession at bay.

Contrary to the hype about continuous robust U.S. economic growth, as measured by GDP and productivity growth, the consumer has in reality drastically retrenched. The great lags in the economy have been and remain capital investment, employment and income growth.

As a result, the U.S. economy, its financial system and its asset markets have become addicted to permanent, profligate credit and debt infusions. Any serious attempt of restraint would therefore send markets crashing and the economy into recession. However it is in the nature of a bubble markets and bubbles economies that something will inexorably collapse them.

It should be clear that the U.S. economy is in much worse shape than it was in 2000 when the equity bubble burst.

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